IN THE

Supreme Court of the United States

OCTOBER TERM, 1961

No. 570

ALBERT GORDON MacRAE and SHEILA MacRAE,

Petitioners,

—v.—

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

REPLY BRIEF FOR PETITIONERS

JEROME B. ROSENTHAL
Attorney for Petitioners
250 N. Canon Drive
Beverly Hills, Calif.

BERNARD SPEISMAN
Of Counsel
711 Fifth Avenue
New York 22, N. Y.

TABLE OF CONTENTS

PAGE

I. Respondent has dealt only in semantics and avoided the actual issues raised by the petition 1

II. Respondent's statements of essential facts distort the issues 6

CITATIONS

Cases:

Kaye v. Commissioner, 287 F. 2d 40 3

Knetsch v. United States, 364 U. S. 361 2, 6

Kraft Foods Co. v. Commissioner, 232 F. 2d 118 2, 5, 11

Stanton v. Commissioner, 34 T. C. 1 2

Statute:

Section 23(b), 1939 I.R.C. 2, 11

IN THE

Supreme Court of the United States

OCTOBER TERM, 1961

No. 570

ALBERT GORDON MACRAE and SHEILA MACRAE,

Petitioners,

—v.—

COMMISSIONER OF INTERNAL REVENUE,

Respondent,

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

REPLY BRIEF FOR PETITIONERS

I. Respondent has dealt only in semantics and avoided the actual issues raised by the petition.

Respondent's brief in opposition to the petition for certiorari herein does not even attempt to contradict petitioner's analysis of the opinions of the courts below, nor does it resolve the various legal questions which arise from the holdings of those courts. Rather, respondent seems anxious to sweep the issues, and petitioner's legal rights, under the carpet, quietly, without due examination by this Court. Petitioner is regretfully forced to this conclusion in view of the misstatements and half-truths which respondent has presented and his reliance on pure semantics in

lieu of rational argument respecting the critical questions of law raised in the petition.

Petitioner's transactions are sham, respondent concludes loftily, therefore the *Kraft Foods* case, 232 F. 2d 118 (C.A. 2), is inapposite, but the *Knetsch* case, 364 U.S. 361, controls. Nowhere does respondent try to deal with the actual language used by the Tax Court in holding petitioner's transactions sham, nor attempt to impugn petitioner's analysis of that language and the legal questions which it raises. Not once does respondent refer to any of the serious discrepancies between this case and the *Stanton* case (34 T.C. 1) which petitioner cited, nor attempt to explain or reconcile these discrepancies.

Respondent has relied on mere semantics in two crucial areas:

A. In the *Stanton* case, respondent blandly asserts, "The taxpayer actually borrowed funds from banks and used the loan proceeds to purchase securities in the open market," whereas "in the present case, there was no real borrowing and no real purchase of any securities." Therefore, the two cases are not inconsistent (Resp. 13-14).

Does respondent mean that only borrowings from banks represent valid indebtedness within Section 23(b)? Wherein does Mr. Stanton's "actual purchase" of bonds differ from the specific purchase of bonds which the petitioner herein directed and which was in fact made by the broker, C-F, in each instance from a regular dealer in such securities—some of the same dealers, in fact, as those from whom Mr. Stanton purchased his securities. Were petitioner's purchases confirmed by the broker C-F to petitioner in any different manner from that in which Mr. Stanton's purchases were confirmed to him, or with any difference in the legal rights of ownership evidenced by such confirma-

tion? What could the *petitioner* have done that *he* did not do? Respondent does not attempt to say: he merely proclaims that petitioner did not purchase securities, etc.

Respondent thus baldly avoids a fundamental question presented by this case. That is whether a short sale effected by a broker or other lender for his own account may be attributed to a borrower whose securities are used by the lender to make delivery against his own short sale, even though the borrower had no knowledge either of the lender's purpose to make a short sale or of the fact of his making the short sale? Only if the short sale may be so attributed at law, can it be said that petitioner did not purchase and own the securities upon which his indebtedness was based.

Respondent obviously begs this crucial question when he merely states as a naked conclusion that there was no real borrowing and no real purchase of securities. That assumption cannot be permitted to stand without examination by this Court, since the legal effect of attributing the lenders' own short sales to the petitioner is tantamount to holding that one party to a contract may, by his independent actions, abridge the ownership and other contractual rights of another party to the contract without the latter's knowledge or consent. Such a "doctrine" is manifestly spurious and unconscionable.

The Tax Court found that petitioner "had no actual knowledge of the mechanics of the transactions as undertaken by C-F and Gibraltar." That finding is unavoidable on the record, and it is controlling. It may not be abridged, as respondent evidently would have it,[1] by innuendo or un-

[1] Petitioner was not in privity with Danny Kaye (287 F.2d, 40, C.A. 9) and the fact that Kaye may have participated in an entirely different type of transaction with the same brokerage house (C-F) cannot abridge petitioner's rights to purchase securities, borrow the purchase price, and deduct the interest paid on his purchase money debt.

warranted association of the petitioner with other taxpayers not in privity with him.

Petitioner himself did nothing different, nothing that is distinguishable in law from that which ever purchaser of securities on credit is obliged to do. He directed the purchase of the securities, he signed notes to cover his borrowings and he gave the lender the right to "rehypothecate or borrow" the pledged securities as every borrower on securities must. Petitioner's business manager, Mr. Norton, reasonably believed that the lenders would rehypothecate the securities with a bank at a lower rate of interest than that paid by petitioner (R. 91), as brokers normally do. He had no reason to suspect, and no way to know, that the lenders intended to sell the securities short. It is a most unusual procedure and it is specious to suppose that a layman could guess it.[2]

Petitioner agreed to pay a higher rate of interest on his loans than the yield he realized on his securities but that is always necessary in borrowing on early maturity securities of the United States, as petitioner proved. The bank or other lender can buy the securities in the open market to obtain the yield for itself and must charge a differential to cover the expense of making the loan (R. 245). Thus, everyone buying these United States Government obligations on credit must sustain a loss in terms of interest cost vs. yield realized.[3] There is no basis for a determination of sham in this or in any other term of the transaction.

---

[2] The procedure is in fact so unusual that it may fairly be open to question whether most persons in the brokerage business would have suspected other than that the securities were rehypothecated in the normal manner.

[3] Thus, Stanton paid 3½ per cent on his loans as against the approximately 1½ per cent yield of the securities which he hypothecated.

The Tax Court held the transactions sham not on factual grounds, but on purely legal grounds which respondent has failed even to mention.

B. Respondent has also relied solely on semantics in respect to the conflict between this case and *Kraft Foods*. The *Kraft Foods* case, *supra*, did, indeed, involve different facts from those presented in the instant case, as respondent indicates, but the issue raised by the Commissioner in that case and decided by the Court of Appeals is precisely the same as that on which petitioner's rights have been determined in the instant case. In the *Kraft Foods* case, the Commissioner argued that the taxpayer's debentures might not be recognized as debentures because there was no purpose in their issuance other than tax avoidance. The Tax Court upheld him, but the Court of Appeals reversed. In the instant case, the Tax Court upheld the Commissioner on the same essential ground and the Court of Appeals affirmed (Pet. 16-17). The issue of sham was present in both cases. In the *Kraft Foods* case, with an apparent display of delicacy, the Tax Court made no express reference to "sham," but it asserted that, although the taxpayer had issued valid enforceable evidences of indebtedness, it had not intended to create indebtedness. The Court of Appeals explicitly discussed the element of sham, and its ruling, in effect, eliminated the existence of sham. In the instant case, it is true, petitioner's transactions have been held sham, but only on the basis of a conclusion of law directly contrary to that applied in the *Kraft Foods* case. The conflict between the two cases is plain, direct. That it arises from different facts makes it all the more significant since it indicates the far-reaching implications of the principle enunciated in the instant case.

Respondent's artful semantics cannot erase the conflict between this case and *Kraft Foods* any more than it can

twist the *Knetsch* case into foreclosing the unrelated issue presented by the holding in this case—whether interest paid on indebtedness to purchase and carry United States Government securities is deductible under Section 23 (b) if no reasonable chance existed of realizing a profit on the purchase apart from the tax consequences (Pet. 11-21).

II. Respondent's statements of essential facts distort the issues.

Only by attributing the lenders' independent short sales to petitioner can petitioner's transactions be disregarded. Whether such attribution is proper on the record is the issue before this Court. Respondent has evidently sought to side-step this issue not only by relying on semantics but by presenting half truths and misstatements, which distort the real issues. Specifically:

1. Respondent states: "As both courts below pointed out (Pet. 53-54, 59-60), whether or not taxpayer knew of the mechanics employed by his agent, the amounts in question are deductible as interest 'only * * * '" etc. (Resp. 12). Nowhere in either opinion of the courts below is there any finding or statement that the lenders acted as the "agents" of petitioner in respect to the loans, nor would such a finding be permissible on the record. The relationship between petitioner and C-F and Gibraltar, the two lenders, is governed by petitioner's margin agreement and his notes. The relationship under these documents is that of borrower and lender, each acting for himself alone. It clearly is not that of an agent obtaining funds for the benefit of the borrower from some third party as the lender; C-F and Gibraltar were themselves the lenders and, as such, were principals under the contracts of loan. Respondent's reference to some "agent" is a pure invention, betraying an

evident lack of confidence in his position under the true facts of the case.

So, too, there is no basis for respondent's oblique reference, earlier in the same paragraph, to taxpayer's contention that he was unaware of the "details" of the transaction (i.e., meaning the lenders' short sales) about which, respondent then proceeds to assert, petitioner had been "generally informed and which he had authorized" (R. 77-78). There is nothing in the record at the point cited by respondent, or anywhere else, to indicate that petitioner or his business managers had been generally informed about any short sale or had authorized any short sale by the lenders. On the contrary, every party to the transactions testified that petitioner had not been informed (R. 82, 91-92, 111, 232). The Tax Court's finding that petitioner did not know about the short sale (Pet. 52) is fully warranted by the record and it is controlling.

2. At the very outset, in his Statement, respondent asserts that petitioner did not seek any details of the transaction respecting the interest rate required on the loan, the rate of return on the Treasury notes, etc. (Resp. 3). However, respondent neglects to mention petitioner's testimony on cross examination, that he relied on his business managers (R. 76-77) and that Mr. Norton, one of his managers had, in fact, shown him the figures relating to the transaction (R. 78). Not only is respondent's statement misleading, but its intended implication is altogether irrelevant. Top flight entertainers, like the petitioner, constantly move from one engagement to another in different parts of the country and, as is commonly known, are generally compelled by circumstances as well as by temperament to rely on agents and managers to handle the "details" of their business affairs. That petitioner relied on business

managers to the extent that he did in this transaction is without special significance to his case.

3. At another point, respondent notes that in the refinancing of petitioner's original loan, on or about January 26, 1953, petitioner directed the original lender, C-F, to deliver the Treasury notes to the new lender, Gibraltar, against payment of $1,020,000, but "C-F did not then have the Treasury notes, and the transfer of the Treasury notes and liability was accomplished by book entries of C-F and Gibraltar" (Res. 6-7). Respondent, however, has omitted mention of the testimony of C-F's accountant that since Gibraltar was a correspondent of C-F, it was entirely regular and proper to reflect the dealings between them in their "omnibus," or reciprocal, accounts (R. 167). The expert capacity of this witness was conceded by respondent (R. 183-4) and the testimony has in no way been impugned. In all instances where actual delivery of securities was necessary to petitioner's transactions, such delivery was in fact duly made.

4. Respondent asserts in his argument that, "• • • neither the finance companies nor the broker-dealer ever actually held any securities. • • • The finance company lacked sufficient funds to make actual loans of the amount it purportedly was lending to the taxpayer • • • The taxpayer never actually received the principal of the 'loans' or the securities supposedly 'purchased' with the loans • • •," etc. (Resp. 11). Respondent here ignores the facts of the case and of normal security financing. Brokers normally rehypothecate their customers' securities with banks in order to obtain the funds required: few, if any, are able to finance all of their customers' margin transactions. Petitioner's business representative testified that he anticipated the lenders would rehypothecate petitioners' securities (R. 91). That is the usual procedure and there was no reason

to expect anything else. And, of course, petitioner "never actually received the principal of the 'loans' or the securities." The principal of the loan was applied in payment of his purchase money obligation and petitioner was entitled to get the securities only when the principal of the loan was paid.

Indeed, the facts which respondent cites are in no way new, and they are beside the issues raised in the petition for certiorari. Respondent cited all of these facts in his brief to the Tax Court. It would have been a relatively simple matter for the Tax Court to hold petitioner's transactions sham in fact, as respondent seeks to imply, if such a finding were justified. The Tax Court did not so hold, but conscientiously determined that petitioner's transactions were sham only because (in its estimation) there was no reasonable chance of realizing a profit apart from tax consequences. The Court's carefully formulated statement in this respect is no accident but was necessitated by the facts and the proof, including petitioner's proof demonstrating the regularity of the brokerage practices which respondent questions (R. 259-278).

5. The same considerations apply to respondent's further statements in the same paragraph (Resp. 11), to the effect that all of the loans except one were made at par value plus the interest coupons to accrue, with refunds of a high proportion of taxpayer's interest payments by the lender to petitioner so that, respondent alleges, "the taxpayer had a minimal out-of pocket expense with respect to the large interest deductions which he claimed." Respondent's implication that petitioner did not pay the full amounts claimed as interest deductions is completely unwarranted. Respondent's own statement of the facts shows that petitioner issued his own checks for the various amounts claimed as interest deductions (Resp. 4-8). In-

deed, this was stipulated by respondent. Petitioner has claimed only the amount of interest which he actually paid. Neither the Tax Court nor the Court of Appeals has held otherwise in this case. If respondent chooses to claim that the refunds by the lenders to petitioner represented a refund of interest, it behooves him to point out also that petitioner paid the amounts represented by his notes in full upon the termination of his transaction. This would raise a further question of law for determination in this case. The years 1952 and 1953 are at issue. One of petitioner's transactions was completed in the latter year. Any contention that the "refund of excess loan funds" by the lender was a refund of interest would merely serve to throw some of the interest into the later year, when the transaction was terminated and fully settled. It does not go to the substance of the petition for certiorari. It is not a talisman of sham, as the Tax Court recognized. On the contrary, the fact that the lenders withheld the amount of petitioner's borrowing in excess of the value of the securities, indicates that the lenders acted prudently, and at arm's length, in normal protection of their interests.

CONCLUSION

Respondent has not even attempted to deal with the actual holding in this case and the questions of law which that holding creates as analyzed in the petition for certiorari. Nor has he resolved the conflict between the holding in the instant case and the *Kraft Foods* case, *supra*, as demonstrated in the petition.

The petition for certiorari should be granted in view of this conflict and of the far-reaching implications of the holding in this case that interest on indebtedness is not deductible under Section 23(b) unless the transaction from which it arose provided a "reasonable chance of realizing a profit" apart from the tax consequences. The petition should be granted, also, in consideration of respondent's evident reluctance to appeal the *Stanton* case and resolve the issue while continuing to disallow the interest deduction in similar cases, as shown in the petition. On these and the other grounds presented in the petition for certiorari, the petition should be granted.

Respectfully submitted,

JEROME B. ROSENTHAL
Attorney for Petitioners

BERNARD SPEISMAN
Of Counsel